

Five key insights for protecting retirement portfolios against inflation risks

For adviser
use only

Inflation in Australia and around the world is returning to levels not experienced by developed economies for decades. Inflation and longevity risks have always been key considerations for retirees, along with the investment risk that is common to all portfolios.

It's yet to be seen whether we will experience a wage-price spiral similar to the one that resulted in double-digit inflation in the 1970s and 1980s. Prolonged high inflation wreaked havoc on investment portfolios due to the loss of real returns. Over the 10 years to December 1979, returns lagged inflation for most Australian investments¹.

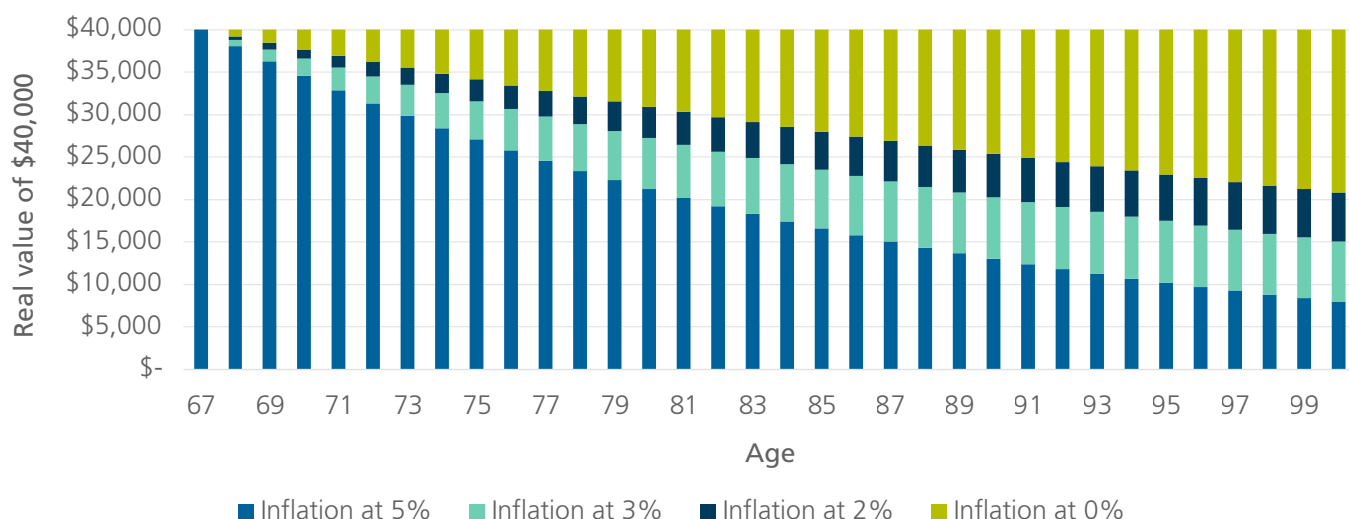
The good news is that the recent Retirement Income Covenant requirements have led to greater innovation in products designed to help manage these risks. In this article, we present insights for advisers to keep in mind as they explore retirement income solutions for their clients in the context of rising inflation.

1. The impacts on income in retirement can be significant

If the current high levels of inflation continue for years rather than months, many retirees could be facing some difficult spending choices. The chart below shows how inflation erodes the real value of income for a retiree

even with moderate levels of inflation. There isn't much difference in the early years, but the impact compounds over time. With inflation running at 5% a year, half the real value of the nominal income is lost after 14 years.

Figure 1: The impact of different inflation rates on retirement income



Sources: ABS, RBA occasional paper #8 and Table G6 labour costs (as released in 2012). Underlying wage data is from the ABS and is based on average male earnings.

Some might argue that a natural reduction in spending is to be expected in retirement and can offset this decline in purchasing power. Research by the Grattan Institute² has shown retirees tend to spend less (in real terms) over time. However, the fall in spending is typically less than inflation, and retirees may not be able to make ends meet simply by reducing discretionary spending. If the cost of energy and groceries both increase, older retirees will not want a situation where they have to choose between cutting back on essential heating or grocery bills.

As retirees don't have the luxury of salary increases to keep up with rising living costs, they are particularly vulnerable to the impacts of a sudden inflation spike or prolonged period of higher than expected inflation. This is compounded by the fact that many retirees in the 21st century are living longer and need to rely on income from their investments for multiple decades as a result.

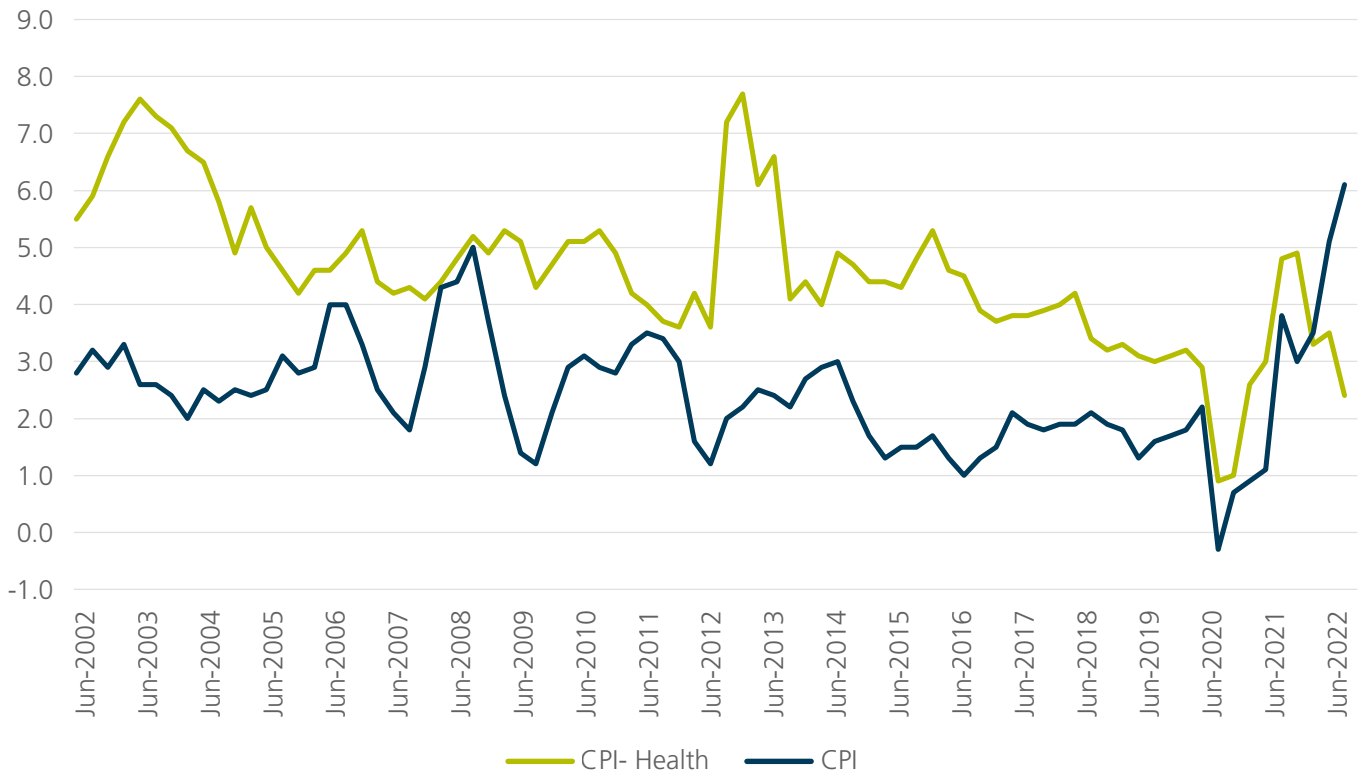
¹ Elroy Dimson, Paul Marsh and Mike Staunton, *Triumph of the Optimists, 101 Years of Global Investment Returns*, Princeton University Press, 2002
² Daley, J., Coates, B., Wiltshire, T., Emslie, O., Nolan, J. and Chen, T. (2018). *Money in retirement: More than enough*. Grattan Institute.

2. Rising health costs could make matters worse

Medical expenses are a cost that will remain, and perhaps increase, later in retirement. A recent National Seniors member survey reveals a high level of concern among retirees about meeting these costs from their income or savings³. Analysis does reveal that the health

component of the CPI has been consistently higher than the overall CPI measure for the past 20 years as seen in the chart below, with the exception being the spike in overall inflation seen in recent months.

Figure 2: Annual Inflation: CPI and CPI-Health June 2002-2022



Source: Minney (2018)

While this trend suggests retirees' fears about health costs are justified, the picture may not be as bleak as it seems. On average the increase in total spending on health is offset by reduction in other spending – on travel or entertainment, for example and a proportion of

costs may also be covered by Medicare. For retirees who do have large out-of-pocket expenses to meet as their health declines, insurance can help limit the impact on their retirement savings and income.

3. The Age Pension offers some protection

The Age Pension provides protection from inflation in two ways. The first comes from the twice-yearly indexation of Age Pension payments. Age Pension payments are increased by the higher percentage increase in the Consumer Price Index (CPI) and the Pensioner and Beneficiary Living cost index (PBLCI).

There is additional inflation protection provided for retirees receiving a part Age Pension. Recipients of a

part Age Pension will see their payments rise by the same dollar amount as the full Age Pension, so they will benefit from greater inflation protection as a proportion of their previous payments. As means test thresholds will also rise in line with either CPI or wages, some Part Pension recipients may see their payments increase if their income and asset position changes in relation to the new threshold.

³ See The evolution of retirement income: A 2022 snapshot - National Seniors Australia August 2022.

4. Market exposure may not be enough to secure lifetime income

When it comes to investments, a safe harbour during a period of high inflation is hard to find. The table below summarises analysis of how effective four common asset classes are as an inflation hedge over different time

frames. For example, research shows a cash investment performs well initially but would only recover 80% of an inflation shock in the long term.

Table 1: Effectiveness of inflation hedges over different timeframes

| Asset class | Short term (<1.5 years) | Intermediate (up to 5 years) | Long-term (5years+) | Long-run real returns |
|---------------|-------------------------|------------------------------|---------------------|-----------------------|
| Cash | Not effective | Improving benefit | Largely effective | Modest |
| Nominal Bonds | Not effective | Losses decline | Not effective | Higher than cash |
| Equities | Not effective | Losses stabilise | Not effective | Highest |
| Commodities | Effective | Effect wanes | Not effective | Low |

Source: Attié, A.P. and S.K. Roache,(2010) Inflation Hedging for Long-Term Investors; IMF Working Paper

Looking beyond these popular asset classes, there are some options that can be more effective in protecting portfolios from inflation impacts. Real assets, such as infrastructure and real estate can provide inflation hedges because the underlying cash flows, such as rent, can be

expected to rise as inflation continues. The asset class best suited as an inflation hedge is short term Consumer Price Index (CPI)-linked bonds as they can provide assurance that investment performance will keep pace with inflation.

5. Income stream options can help

Selecting from this range of assets can help advisers manage the risk of unexpected inflation to capital. In retirement, it is the impact of inflation on an income stream that needs to be managed. There are a growing range of retirement income stream options that can help advisers and their clients to achieve this goal.

Account-based pension

An account-based pension provides the most flexible option for retirees seeking to make income withdrawals that keep pace with inflation. A retiree can simply draw more money from one year to the next to offset the impact of inflation, subject to regulatory minimums. However, this can introduce a higher degree of longevity risk – running out of money if market returns are lower than expected or spending is higher than planned.

Guaranteed CPI-linked lifetime annuity

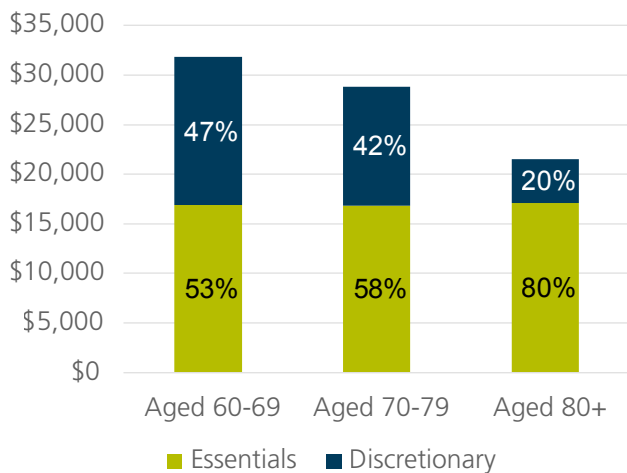
Using this option, retirees receive an income stream for the rest of their life that adjusts in line with CPI changes. In Australia, the guaranteed annuity is provided by a life insurance company that is supervised by the Australian Prudential Regulation Authority (APRA). APRA aims to ensure that the life insurer maintains enough capital to pay the guaranteed amounts to the annuity holder, no matter what happens in markets or how long people live.

Market-linked lifetime annuity

As a relatively new development in annuities, market-linked lifetime annuities provide payments that increase in line with the performance of either an underlying diversified portfolio or a nominated basket of market indices. The payments will change as markets move, falling at times as well as increasing. These solutions can potentially provide adequate inflation protection for a retiree's income. On average over the long term their annuity income can be expected to increase by more than inflation. However the payments cannot be relied on to always grow faster than the CPI and there is also sequencing risk to consider – payments could take a long time to recover from a decline in markets early in retirement.

There are ways to help retirees optimise their drawdown from a market-linked lifetime annuity so that income payments better match their spending patterns in retirement. As discussed earlier spending tends to decline in real terms over retirement. By providing higher payments at the start of retirement, and with payments increasing below market returns year-on-year, this approach can deliver more income and inflation protection early in retirement when clients are likely to have higher discretionary income needs and a higher household budget overall.

Figure 3: Spending patterns for single households by age, 2015-16



Source: Minney (2018)

The growing range of income stream options is providing retirees with alternative ways of managing the impact of inflation on their retirement income. Retirees can choose the type of inflation protection that they prefer, from none to a guaranteed CPI-linked option to approaches that should work but retain some market risks. This is in addition to the option to draw down capital, adjusting for inflation as desired.

To find out more about inflation protection in our lifetime annuity products get in touch with your BDM or contact us on 13 35 66.

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